AUDITOR INDEPENDENCE, ‘LOW BALLING’, AND DISCLOSURE REGULATION

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This paper investigates the allegations of the Commission on Auditors’ Responsibilities and the Securities and Exchange Commission that ‘low balling’ on initial audit engagements impairs auditor independence. We demonstrate that, contrary to these claims, ‘low balling’ does not impair independence; rather it is a competitive response to the expectation of future quasi-rents to incumbent auditors (due, e.g., to technological advantages of incumbency). ‘Low balling’ in the initial period is the process by which auditors compete for these advantages. Critically, initial fee reductions are sunk in future periods and therefore do not impair auditor independence. The implications for current regulation governing changes of auditor (Accounting Series Release No. 165 et al.) and audit fees (Accounting Series Release No. 250) are also discussed.

1. Introduction

The practice of ‘low balling’ (setting audit fees below total current costs on initial audit engagements) has been cited by both the Securities and Exchange Commission and the Commission on Auditors’ Responsibilities (Cohen Commission) as impairing auditor independence. While both parties have expressed concern about ‘low balling’, neither has established a causal link from this pricing practice to impaired independence. In other words, policy-makers lack a positive theory which ties the intertemporal fee structure of audit services to auditor independence. The purpose of this paper is to provide that link. We argue that the existence of client-specific quasi-rents to incumbent auditors both lowers the optimal amount of auditor independence and leads to ‘low balling’ in the initial period. Importantly, while these two effects are associated, ‘low balling’ does not itself impair auditor independence.

The expressed regulatory and professional view, however, is just the opposite. For example, the Report of the Commission on Auditors’

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Responsibilities (Cohen Report) claims that ‘low-balling’ itself impairs auditor independence by generating a receivable from the client similar to an unpaid audit fee. Outstanding audit fees are proscribed by both the American Institute of Certified Public Accountants and the SEC because of their perceived negative impact on auditor independence. According to the Cohen Report (p. 121, emphasis added): ‘We believe that accepting an audit engagement with the expectation of offsetting early losses or lower revenues with fees to be charged in future audits creates the same threat to independence’ (as an unpaid audit fee). The allegation that ‘low balling’ impairs auditor independence has led the Cohen Commission to suggest that the Ethics Division of the AICPA should devote resources to the study of this ‘problem’.¹

The SEC has also expressed concern that ‘low balling’, i.e., price competition among auditors, may lead to an overproduction of dishonest reporting. In particular, the SEC is concerned that ‘situations where the auditor agrees to a fee significantly less than is normal in order to obtain the client’ may constitute a lessening of independence (Securities Act Release No. 33-5869). Accordingly, Accounting Series Release No. 250 requires disclosure of ‘fee arrangements where the accountant has agreed to a fee significantly less than a fee that would cover expected direct costs in order to obtain the client’.

Despite professional and regulatory concern, ‘low balling’ on initial audit engagements appears to be a common practice.² Furthermore, ‘low balling’ is

¹Others have argued that ‘low balling’ is also ‘anticompetitive’ and ‘unfair’ to small firms [see, e.g., the discussions in Causey (1979, pp. 185-186), Arnett and Danos (1979, pp. 5-7), and in the Metcalf Report (1976, pp. 1729-1730)]. The concern of the present paper is not the alleged predatory effects of ‘low balling’, but its alleged negative impact on auditor independence. For a discussion of why predatory price tactics in general are likely to be a dominated strategy, see McGee (1958).

²Casual evidence gathered by the Cohen Commission supports the prevalence of ‘low balling’ to obtain initial audit engagements:

... the experiences of some members of the Commission and staff indicate that fee competition is common and increasing.

Discussions with a few companies that have recently negotiated with new auditors indicated readiness on the part of public accounting firms to offer competitive prices, to make bids with fees guaranteed for several years, to renegotiate prices after receipt of competitive offers, and to set billing rates at as much as 50 percent below normal (p. 110)

A recent article in the New Orleans newspaper, The Times-Picayune (March 23, 1979), reports on the practice of ‘low balling’ in conjunction with the audit of the city of Slidell:

Leonard Brook of Deloitte, Haskins and Sells said his firm expected just to break even on the first city audit at a charge of $16,000. ‘I’d be amazed if it can be done for $25,000’, said Brook, who admitted his firm was submitting a low proposal the first year in order to do business with the city in succeeding years. . . .

A fee of $15,000 — lowest of the four — was proposed by Wally Giles and Eugene Fremaux of Price-Waterhouse. ‘In reality, that fee does not constitute what our full rate would be if we didn’t absorb the first year’s start-up cost’, said Giles (sec. 1, p. 6).
not confined to auditing; rather, it is observed in such diverse environments as bidding for franchise contracts [see, e.g., Goldberg (1976, p. 437)], bidding for cable television monopolies [Williamson (1976)], bidding for input contracts [Williamson (1975, p. 93)], and initial payments for future franchise rights [Rubin (1978, p. 226)]. For example, Williamson (1975, p. 93) discusses the initial competition to become the supplier of spark plugs to Ford Motor Company. Apparently this contract gave the winner significant advantages in the replacement market and ‘Ford was able to purchase plugs at much less than cost on this account’.

A non-auditing example of ‘low balling’ commonly observed today is the distribution of free samples when a manufacturer brings out a new product. Clearly, the price of these samples (zero) is less than their total current cost to manufacture, and yet these inducements apparently are of little concern to regulators. What then is different about auditing?

The crucial difference between ‘low balling’ in general and ‘low balling’ by auditors lies in its alleged negative impact on auditor independence. In order to analyze the link between this fee structure and independence, we first provide a definition of auditor independence which is equivalent to one offered by Watts and Zimmerman (1980) (section 2).

When contracting is costly, certain aspects of the audit environment (e.g., technological advantages to incumbent auditors and significant transactions costs of changing auditors) enable incumbent auditors to earn quasi-rents on future audits of a given client (section 3). These expected future quasi-rents induce ‘low balling’. The reason is that competition among auditors for the right to become the incumbent (and capture the quasi-rents) drives fees below total costs in the initial period. Critically, initial fee reductions are sunk in future periods and therefore do not impair auditor independence. The implications for current regulation governing audit fees (Accounting Series Release No. 250) and auditor changes (Accounting Series Release No. 165 et al.) are also developed (section 4). Conclusions and a brief summary are provided (section 5).

2. The economic benefits of auditor independence

The ex ante value of an audit to consumers of audit services (which include current and potential owners, managers, consumers of the firm’s products, etc.) depends on the auditor’s perceived ability to

1. discover errors or breaches in the accounting system, and
2. withstand client pressures to disclose selectively in the event a breach is discovered.

In order to concentrate on independence (rather than on an auditor’s
technical capabilities), we assume that the probability of discovering a breach is positive and fixed. The level of auditor independence is defined as the conditional probability that, given a breach has been discovered, the auditor will report the breach.

For his opinion to have value in the capital market, the auditor must have some incentive to tell the 'truth' when the truth is 'bad news' from the client's perspective. This analysis does not imply that the audit opinion is valueless unless the auditor always tells the truth. Rather, the greater the incentive for the auditor to tell the truth, the greater the value of the auditor's opinion. If the capital market expected the auditor never to deviate from management's position, then it would assess the value of the auditor's opinion as zero. Therefore, in at least some cases, the capital market must expect the auditor to oppose management.

On the other hand, as Watts and Zimmerman have argued, it is unlikely that auditors are perfectly independent from their clients. By definition, there is perfect independence when the conditional probability that the auditor will report a discovered breach is one. A necessary condition for the optimal amount of independence to be less than perfect independence is the expectation by the author of future quasi-rents specific to a given client relationship.

A given period's client-specific quasi-rent equals the excess of revenues over avoidable costs, including the opportunity cost of auditing the next-best alternative client. Quasi-rents arise naturally in a multiperiod world when agents invest in the current period with the expectation of return in future periods. With a positive initial investment, future revenues must exceed future (avoidable and unavoidable) costs in order that the project be undertaken. The expectation of future quasi-rents does not imply that auditors earn monopoly rents. A future quasi-rent stream constitutes a monopoly rent only when the net present value of the investment is positive. When the net present value of the investment is zero, the quasi-rent stream yields a normal rate of return on an initial outlay.

If no client-specific quasi-rents are expected from a given client relationship, an auditor is indifferent to termination of that relationship; consequently he has no economic incentive to conceal a discovered breach. In this case, the auditor is perfectly independent with respect to that particular client. The existence of perfect substitutes for a given client (with zero transactions costs of switching) implies the absence of client-specific

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3 In reality, these two probabilities are unlikely to be separable, e.g., how thoroughly an auditor searches for a breach depends on his expectations about subsequent disclosure. For simplicity, we treat them here as separable. This definition of auditor independence is equivalent to one put forth by Watts and Zimmerman (1980, p. 8).

4 For a more extensive discussion of the distinction between quasi-rents and monopoly rents, see Klein, Crawford and Alchian (1978, p. 299).
quasi-rents,\(^5\) and therefore also implies perfect auditor independence.\(^6\)

Thus, as the accounting profession has long argued, ‘future economic interest’ in a given client lessens auditor independence with respect to that client.\(^7\) And ceteris paribus, the greater the client-specific quasi-rent stream (the more the auditor stands to lose by client termination), the lower the conditional probability that he will report a discovered breach. It follows that the greater the observed economic interest (e.g., the greater the auditor’s ownership interest in the client firm), the lower the perceived probability that the auditor will report a breach.

In an efficient capital market, rational agents forecast that auditors who possess a known economic interest in their clients have increased incentives for misrepresentation; the expected costs resulting from these incentives are reflected in the client’s share price. Since auditor independence has potential benefits to clients (through its impact on firm value) and to auditors (through the fees they can charge for audit services), both parties have incentives to voluntarily choose contractual arrangements which enable them to capture the expected net benefits of auditor independence.

If contracting among agents were costless, auditors would always be perfectly independent\(^8\) from their clients. Perfect independence would result from an exhaustively specified and perfectly enforced contract negotiated (at zero cost) in the initial period. In other words, auditors and clients could capture the benefits to perfect independence at zero cost. However, in an important sense it is internally inconsistent to assume costless contracting in an auditing context. After all, costless contracting also enables firm owners and managers to remove conflicts of interest, and therefore implies a zero demand for (costly) auditing and other monitoring technologies. It follows that a necessary condition for both (1) a positive demand for costly auditing, and (2) less than perfect auditor independence is that contracting among agents be costly. Therefore, we shall maintain the costly contracting assumption throughout the paper.

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\(^5\)Recall that the costs of auditing a given client are appropriately defined to include the opportunity cost of auditing the next-best alternative client.

\(^6\)Conversely, the absence of (costlessly available) perfect substitute clients implies less than perfect auditor independence. An auditor who expects to earn client-specific quasi-rents from a given relationship is not indifferent to client termination, and is therefore not perfectly independent with respect to that client. This statement is subject to the caveat set forth in footnote 7.

\(^7\)Future economic interest is necessary but not sufficient for misrepresentation. In addition, the auditor must perceive the expected gains from ‘cheating’ exceed the expected costs. These expected costs will incorporate the present value of the loss in future audit fees resulting from the loss of reputation, should the auditor be caught ‘cheating’, and the probability of being caught.

\(^8\)It is important to note that perfect independence is a ‘Nirvana-type’ construct useful only as a benchmark. The observation that the optimal amount of auditor independence is not perfect independence has no normative implications; rather it is to be expected in a world of costly contracting.
3. ‘Low bailing’ and auditor independence

When contracting is costly, incumbent auditors who possess a comparative advantage over competitors in future periods expect to earn quasi-rents. For example, when client-specific start-up costs are significant, the incumbent auditor enjoys a technological advantage on future audits of a given client. Transactions costs of changing auditors (e.g., disclosure requirements) also create advantages to incumbents. Incumbent auditors can capture future benefits from technological and transaction cost advantages by setting future audit fees above the avoidable costs of producing audits. Therefore, these advantages represent assets to incumbents which are specialized to both the auditor and a particular client.

The specialized nature of these shared assets implies that the future relationship between client and incumbent auditor is a bilateral monopoly. Each party can impose real costs on the other by termination; each can potentially gain, therefore, from the threat of termination. Clients can potentially gain concessions such as selective disclosure. Auditors can potentially raise audit fees. Rational clients and auditors anticipate the future bilateral monopoly when contracting for initial audit engagements and their expectations are reflected in the equilibrium fee structure.

In particular, when incumbent auditors earn quasi-rents, competition among auditors for the initial engagement, i.e., for the property rights to incumbency, results in ‘low bailing’ (setting initial audit fees less than current total costs). A simplified model which illustrates this process is presented below. It is important to note at the outset that ‘low bailing’ is a general result which in no sense depends on the assumptions of this simple model. Rather, ‘low bailing’ occurs in settings where

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9 It is well recognized in the literature that initial audit engagements entail significant start-up costs. Arens and Loebbecke (1976, p. 100) provide three reasons for this phenomenon:

1. It is necessary to verify the details making up those balance sheet accounts that are of a permanent nature, such as fixed assets, patents, and retained earnings.
2. It is necessary to verify the beginning balances in the balance sheet accounts on an initial engagement.
3. The auditor is less familiar with the client’s operations in an initial audit.

10 To the extent that start-up costs are not client-specific (e.g., some portion is marketable to other auditors or transferable to the auditor’s other clients), client-specific quasi-rents to incumbents are reduced. The advantages to incumbency which we are concerned here are those which are completely client-specific, i.e., whose value in alternative uses is zero.

11 When information is costly, unanticipated broken agreements (opportunism) can still occur. For example, auditors may promise a given fee structure, and then opportunistically renege, perhaps claiming ‘cost overruns’. It is, of course, costly for clients to determine whether costs have actually increased or whether the auditor is ‘gouging’ him. On the other hand, clients may initially promise to retain the auditor, encouraging him to bear some of the start-up costs, and then opportunistically terminate him to take advantage of unanticipated future events. This behavior occurs when it is costly for outsiders to determine (and perhaps verify) that the auditor was fired opportunistically rather than for cause. Potential costs to loss of reputation (e.g., clients who are shown to ‘cheat’ auditors must pay higher audit fees, auditors who are shown to ‘cheat’ clients may lose other clients) govern the extent to which opportunism will occur.
(a) incumbent auditors earn quasi-rents, due, e.g., to transactions costs or technological advantages, and
(b) the initial market for audit services is competitive.

Conditions (a) and (b) are obviously met in many more complex environments than the simple one which follows.

Consider a multiperiod \( t = 1, 2, \ldots, \infty \) model in which the market for initial audit engagements at time \( t = 1 \) is perfectly competitive insofar as all potential auditors have identical technological capabilities. The market for subsequent audits (in future periods \( t = 2, \ldots, \infty \)) is not perfectly competitive because incumbent auditors possess cost advantages over potential new auditors. The incumbent’s advantage arises because new auditors must bear technological start-up costs (which are sunk costs to incumbents) and because of the transactions costs of switching auditors. Consequently, incumbent auditors expect to earn quasi-rents on subsequent audits and ‘low balling’ in the initial period is the competitive response required to capture the quasi-rents.

Formally, let \( A_t \) represent the cost of producing an audit in time period \( t \). Thus, \( A_1 \) represents the cost of producing the initial audit, and \( A_2, A_3, \) and so on represent the production costs of subsequent audits. For analytical simplicity only, assume that all subsequent audits are produced at the same cost each period, \( A = A_2 = A_3 = \ldots = A_\infty \). The initial audit requires a start-up cost of \( K \) which dictates total production costs of \( A_1 = A + K \) for initial audits. This simple intertemporal cost structure is illustrated in fig. 1 for the special case of four time periods.

![Fig. 1. Audit costs per period (\( A \) is audit cost, \( K \) is the start-up cost in period 1, \( A_1 = A + K \) is audit cost in period 1).](image-url)
In each time period \( t \), the client contracts to pay the auditor a fee, \( F_t \), to produce that period's audit. Thus, \( F_1 \) represents the auditor's fee on the initial engagement and \( F = F_2 = F_3 = \ldots = F_\infty \) represents fees on subsequent audits, assumed for simplicity to be equal in periods \( t = 2, \ldots, \infty \).

With this preparation, we can characterize the endogenously determined intertemporal fee structure. In particular, we will show that competition for the initial audit engagement among auditors with rational expectations leads to a market equilibrium in which 'low balling' obtains. In symbolic terms, the equilibrium price structure requires that initial fees be set below costs: \( F_1 < A_1 = A + K \).

Viewed at time \( t=1 \), the present value of each potential auditor's profit from obtaining the initial engagement for a given client is

\[
\pi = (F_1 - A_1) + (F - A)/r. \tag{1}
\]

The first term of eq. (1) is the profit on the initial engagement and the second term is the discounted (at rate \( r \)) profit or quasi-rent stream from subsequent audits of this client.\(^{12}\) The equilibrium initial audit fee, denoted \( F_1^* \), depends on current costs, \( A_1 \), and on the present value of future quasi-rents, \((F - A)/r\).

Importantly, future audit fees exceed the avoidable costs of production \((F - A > 0)\) so that the incumbent auditor earns quasi-rents on subsequent audits of this client. To see why, first recognize that \((F - A)\) must be non-negative because the incumbent auditor can (and will) withdraw from the engagement if total costs exceed total revenues on any subsequent audit. While any start-up costs incurred in the initial period are sunk, the incumbent auditor will not supply future audit services if audit fees are insufficient to cover the avoidable costs of producing audits. Thus, in each future period, the incumbent auditor's avoidable costs, \( A \), constitute a lower bound on audit fees.

The upper bound on the incumbent's future fees depends on both the alternative supply price and the transactions costs of changing auditors. In this model, each time a client switches auditors, he incurs a transactions cost, denoted \( CS \), in the period of the switch. Therefore, clients will change auditors only if they perceive that the present value of the incumbent's fees exceeds the present value of a new auditor's fees plus the transactions cost of changing auditors.\(^{13}\) Formally, the client's switching decision is

\[12\]Eq. (1) implicitly assumes that the initial auditor retains the engagement in perpetuity. This condition is derived below assuming that incumbent auditors always set future fees to be entry preventing (see footnote 14).

\[13\]This statement is strictly correct only when audit quality is held constant. When audit quality varies inversely with rents to incumbents, clients will change auditors when they perceive that the present value of the incumbent's fees plus the (negative) impact on client firm value of retaining the incumbent exceeds the present value of a new auditor's fees plus the costs of changing auditors. Allowing audit quality to vary complicates the analysis without altering the 'low balling' result.
straightforward in this simplified setting: retain the incumbent auditor in every future period as long as

\[ F < A + r \frac{(CS + K)}{1 + r}. \]  

To see why eq. (2) is entry preventing, note that new auditors hired at \( t = 2 \) incur start-up costs on the initial audit so that \( A_2 = A + K \) and \( A = A_3 = A_4 \) and so on. Competition among new auditors at time \( t = 2 \) assures that they earn zero profits. Therefore the discounted present value of a new auditor’s fees equals the discounted present value of his total costs, \( A_2 + A/r \). The present value of the incumbent’s fees at time \( t = 2 \) is \( F + F/r \). The incumbent’s entry preventing fee must therefore satisfy

\[ F + F/r < A_2 + A/r + CS, \]

where \( A_2 = A + K \) which simplifies to eq. (2). The same logic applies to periods \( 3, 4, \ldots, \infty \).

Thus, the incumbent auditor’s future fees lie in the range

\[ A \leq F < A + r \frac{(CS + K)}{1 + r}. \]  

The equilibrium fee depends, in general, on the bilateral negotiation process in future periods. By inspection of (3), one can easily see that when both \( CS = 0 \) and \( K = 0 \), audit fees equal avoidable production costs in every future time period. In this case, the market for subsequent audits is perfectly competitive because all auditors possess identical technologies with zero adjustment costs: perfect competition in each future period drives the quasi-rents to zero. It follows that ‘low bailing’ does not occur because incumbents possess no advantages.

Under the assumptions of the current model, the winner of the initial bidding at \( t = 1 \) can prevent entry in each future period\(^{14} \) by setting future fees such that (2) is satisfied. For simplicity only, assume that the incumbent auditor sets \( F \) in order to extract the maximum entry-preventing quasi-rent. Formally, the auditor sets future fees such that

\[ F^* = A + r \frac{(CS + K)}{1 + r} - \varepsilon, \]

where asterisks denote equilibrium values and \( \varepsilon \) is some arbitrarily small positive number. When \( CS > 0, K > 0 \), future fees are set such that \( F^* - A > 0 \), i.e., incumbents extract positive future quasi-rents.

\(^{14}\)Because the incumbent auditor always sets future audit fees to prevent entry, clients will not change auditors in this model. In a more general model, clients change auditors when audit quality varies (see footnote 13) and/or competitors’ fees are stochastic. With future quasi-rents reinterpreted in expected value terms, ‘low bailing’ still obtains in market equilibrium.
Auditors bidding for the initial engagement hold rational expectations about the future advantages to incumbency and submit initial bids based on these expectations. Competition for the initial audit (i.e., for the property rights to incumbency) will force auditors to lower their initial bids until zero profits are expected (in net present value terms). In other words, auditors bidding for the initial engagement will 'low ball' until the expected rate of return on the foregone fees in the initial period is a normal one. Thus, in market equilibrium, eq. (1) becomes

$$\pi^* = (F^*_1 - A_1) + (F^* - A)/r = 0.$$

As demonstrated above, the second term of (4) is positive. By the competitively-enforced zero profit condition, the first term is negative, and 'low balling' is established, i.e., market equilibrium requires that initial fees be less than production costs,

$$F^*_1 - A_1 < 0.$$

Fig. 2 illustrates the equilibrium intertemporal fee structure in the special case of a four-period model. Note that the discounted value of the area labelled 'future quasi-rents' equals the area labelled 'low ball' discount when auditors earn zero profits at equilibrium. By inspection of fig. 2 [and of eq. (4)], one can also see that the greater the expected future rents, ceteris paribus, the greater the 'low balling' for the property rights to those rents.

This effect of bidding 'for the market' has been previously analyzed by Demsetz (1968, p. 65), Williamson (1971, p. 116), and Posner (1976).
A number of factors have been ignored in the simplified model. In particular, potential benefits to independence (section 2) provide the parties with incentives to devise contracts which reduce client-specific quasi-rents to incumbent auditors (and thereby raise the level of auditor independence). Negotiated contracts may be implicit (e.g., client and auditor reputation) or explicit (e.g., engagement letters which typically specify the scope of the engagement, audit fees, responsibility for inputs, etc.). In addition, both auditors and clients have incentives to refrain from explicit vertical integration, contingent fee structures, auditor ownership of client firm securities, and other practices that are expected to affect negatively the perceived independence of the auditor.

When considering contractual responses, one might be tempted to argue that the level of independence can be increased by an agreement to set $F^*_1 = A_1$, i.e., to preclude 'low bailing' in the initial period. In fact, this solution is ineffective in reducing quasi-rents (and raising the level of independence). To see why, note that the line of causation runs from anticipated future rents to 'low bailing' in the initial period, not vice versa as regulators as the Cohen Commission have suggested. 'Low bailing' for the initial audit is a competitive response to future rents to incumbents; 'low bailing' does not cause future rents to occur. Because initial fee reductions are sunk in future periods they have no effect on either (i) the magnitude of future rents, or (ii) auditor independence.

By parallel reasoning, agreements to refrain from 'low bailing' in the initial period are also sunk, i.e., irrelevant in future periods, and thus do not prevent incumbent auditors from raising future fees above avoidable production costs. In other words, the incumbent's future fee-raising potential is unchanged by these initial agreements. Rational clients recognize this fact and are unwilling to agree to contracts whose sole purpose is to reduce 'low bailing' in the initial period. While contracts which reduce client-specific quasi-rents increase the level of auditor independence, those which simply reduce 'low bailing' in the initial period have no effect on independence. Thus, potential benefits to independence provide joint incentives to negotiate the former, but not the latter type of contractual agreement.

4. Implications for current disclosure regulation

The logical framework developed in earlier sections can be used to evaluate the effects of current regulation intended to increase the level of

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16See Macaulay (1963) for discussion of the use of explicit and implicit contracts in business relationships.

17While explicit vertical integration (i.e., client ownership of the audit firm, as with internal auditors) is not feasible for auditor–client contracting, the length of the relationship is endogenous. Obviously, the longer the relationship, the more it approaches vertical integration.

18In fact, this may have been the SEC's reason for imposing sanctions on 'low bailing' in ASR-250, as discussed in the next section.
auditor independence. Two sets of rules are considered: ASR-165 et al. governing auditor changes and ASR-250 governing auditor-client fee relationships. The expressed intent of both sets of rules was to increase auditor independence by increased disclosure of the circumstances surrounding a change of auditor (ASR-165 et al.) and the contractual, in particular, the fee relationship between clients and auditors (ASR-250).

The logic underlying ASR-165 et al. is that increased disclosure of auditor changes reduces the client’s ability to extract accounting concessions from the auditor by threatening to terminate the relationship. The Cohen Commission supports the SEC’s position on auditor changes because ‘measures that increase the outside scrutiny of a change in independent auditors are likely to inhibit the tendency to apply pressure to the independent auditor by threatening dismissal’ (Cohen Report, p. 107).

While it is true that increased outside scrutiny renders client threats of termination less effective, the Cohen Report’s analysis is overly simplistic. Both the Cohen Commission and the SEC overlooked an important offsetting effect of ASR-165 et al. By raising the costs of changing auditors (raising CS in the model), ASR-165 et al. raises client-specific quasi-rents to incumbent auditors, which, ceteris paribus, reduces the optimal level of independence. Thus, contrary to accepted doctrine, the net effect of ASR-165 et al. on auditor independence is indeterminate.

Despite the ambiguous net impact on auditor independence, the effect of ASR-165 et al. on audit pricing is straightforward: by raising the costs of switching auditors, this regulation raises future quasi-rents to incumbent auditors. When competition among auditors for the rights to the increased future quasi-rents occurs on price dimensions, initial audit fees are lowered, i.e., more ‘low balling’ occurs. While ASR-165 et al. is predicted to increase

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19 Four rules are relevant to auditor changes: Securities Release No. 34-9344 (effective October 31, 1971), ASR-165 (effective January 1, 1975), ASR-194 (effective August 31, 1976), and ASR-247 (effective July 31, 1978). The principal reporting requirements under ASR-165 et al. are disclosure of both the resignation of the prior accountant and the engagement of the new accountant, and the existence of any significant disagreement with the prior accountant within the two most recent fiscal years. The client must request that the prior accountant respond to the filing, and his response is appended as an exhibit. In addition, financial statement disclosure of the effect of the disagreement, if material, is required.

20 ASR-250 requires disclosure of the services provided by the principal accountant and the percentage relationship of non-audit fees (if material) to audit fees. Any limits on audit fees (current or future) that are not subject to renegotiation if unanticipated difficulties develop require disclosure as well. While Securities Act Release No. 33-5869 proposed that the dollar amount of audit fees be disclosed, ASR-250 does not require disclosure of the magnitude of audit fees.

21 Furthermore, ASR-165 et al. may have enabled existing incumbent auditors to earn monopoly rents by causing an unanticipated increase in the future rent stream. As such, this regulation represents a wealth transfer from clients to extant incumbent auditors. Auditors bidding for incumbency subsequent to the regulation do not benefit to the extent that competition dissipates any gains.
'low bailing', ASR-250 attempts to reduce it and therefore these two rules appear to be inconsistent.

The apparent inconsistency between ASR-165 et al. and ASR-250 raises the question of intent: if there is no causal relationship between 'low bailing' and impaired independence, why the professional and regulatory concern over 'low bailing'? One potential explanation is that these parties fail to recognize the sunk cost nature of initial fee reductions and mistakenly believe that imposing sanctions on 'low bailing' raises the level of auditor independence. An alternative hypothesis is that the expressed concern over 'low bailing' is an 'excuse' for an attempt to preserve monopoly rents to auditors.²²

To show why the second explanation is plausible, we draw on the audit pricing model to predict the joint economic consequences of ASR-165 et al. and ASR-250. Recall that an auditor's profit from a given client can be expressed as eq. (1),

\[ \pi = (F_1 - A_1) + (F - A)/r, \]

where future fees, \( F \), are an increasing function of the transactions costs of switching auditors.

By raising these costs, ASR-165 et al. raises the second term in (1), which represents the present value of the auditor's quasi-rent stream from future audits of this client. At equilibrium, fee competition among auditors for the initial audit assures that the first term adjusts to maintain the equilibrium zero profit condition.

However, if sanctions against 'low bailing' (as, e.g., in ASR-250) can effectively prevent the first term of (1) from adjusting via initial price competition, auditors earn monopoly rents, \( \pi^* > 0 \), at least initially. In effect, regulation lowers the cost of monitoring (explicit or implicit) price-fixing agreements which would aid a cartel of auditors in sustaining monopoly pricing. However, it is unlikely that monopoly rents can be sustained in the long run because innovative auditors will substitute into non-price competition (e.g., more brochures on accounting issues, more attractive personnel) to obtain the initial engagement. This substitution occurs because incumbent auditors continue to earn future quasi-rents subsequent to regulation. Thus, auditors will 'low ball' (on non-price dimensions) to obtain

²²For a positive theory of the demand for accounting 'excuses', see Watts and Zimmerman (1979). It should be noted that regulation governing audit fees is potentially a means of raising independence by lowering future client-specific quasi-rents. In other words, government-enforced limits on future fees may be the minimum cost contractual response to these quasi-rents. However, ASR-250 makes no attempt to limit future fees, and therefore is not of this genre of contractual response.
the initial engagement and thereby dissipate the monopoly rents.\textsuperscript{23} Furthermore, to the extent that client-specific quasi-rents are unchanged by the regulation, auditor independence is unaffected by ASR-250.

5. Conclusions

This paper develops a model of intertemporal audit pricing when incumbent auditors possess cost advantages over competitors in future audits of a given client. These advantages occur due to significant start-up costs in audit technology and transactions costs of switching auditors. When incumbent auditors possess these advantages, they can raise future audit fees above the avoidable costs of producing audits, i.e., incumbent auditors earn client-specific quasi-rents.

The expectation of client-specific quasi-rents to incumbent auditors has two effects. First, it implies that the optimal level of auditor independence is less than perfect independence. In fact, client-specific quasi-rents to incumbency are a necessary condition for lessened independence. Second, competition for the property rights to incumbency forces auditors to 'low ball' in the initial period.

Regulators and the profession have claimed that 'low balling' impairs auditor independence by itself creating a future economic interest in clients. Contrary to these assertions, the current paper demonstrates that 'low balling' is a competitive response to the expectation of future quasi-rents, and does not itself impair independence. Regulation which attempts to curtail 'low balling' (without altering the client-specific quasi-rent stream) is predicted to have no effect on auditor independence.

\textsuperscript{23}To the extent that the regulation of price competition causes auditors to supply services whose costs are greater than their value to clients, it induces a misallocation of resources as monopoly rents are dissipated.

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